Alfa-Bank

Macro Insights

AB-ICI: Down on sanctions

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Investment Summary

- AB-ICI down 3.9% in July on weak economic, market and foreign confidence
- Market has to price in economic effect of previous sanctions, faces new round of pressure
- Strong inflationary pressure is the key economic implication of sanctions at the moment

AB-ICI down 3.9% in July, reacting to sanctions

AB-ICI down 3.9% in July

As we indicated in our previous notes, the introduction of sanctions against Russia has sent the AB-ICI down. Our index declined 3.9% in July, reflecting a contraction of all three components:

Poor GDP growth …

- **Economic confidence** declined due to ongoing net capital outflow as well as negative economic news. Indeed, not only was Russia's GDP down 0.2% y/y in July, but this poor statistic also raises a number of concerns on the sustainability of retail trade growth;

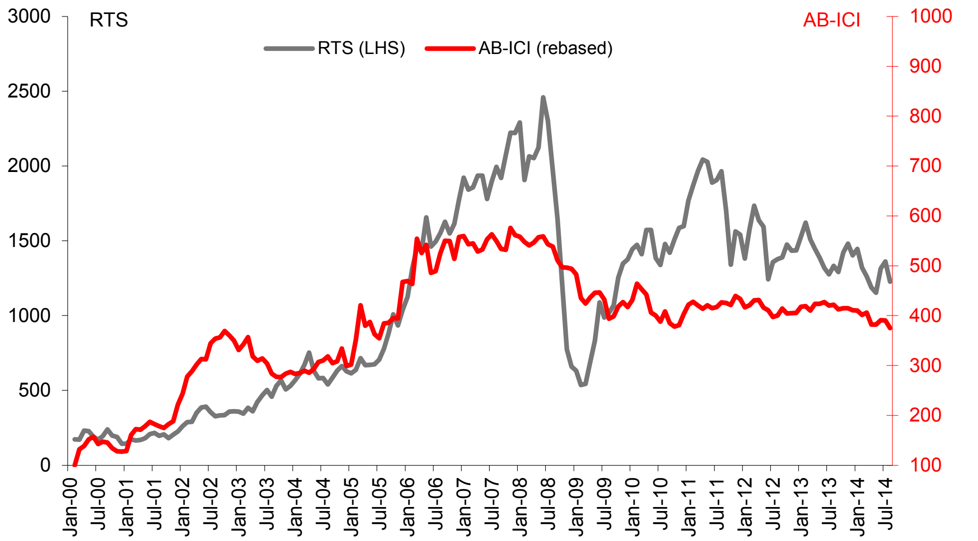
… decline in foreign bank presence …

- **Foreign confidence** was down, as the share of foreign banks in total banking sector assets declined. Given the exchange of sanctions that is becoming ever more prevalent, it appears that foreign confidence is likely to remain under pressure going forward;

… and market contraction hit index performance

- **Market sentiment** is down, as all components have reacted negatively to the EU's decision to join sanctions as well as to the US' widening of sanctions. Russia is becoming an "avoid" asset for a number of foreign investors, which is reflected in the dynamics of the equity, bond and exchange rate markets.

Figure 1: AB-ICI down 3.9% in July



Source: New Economic School, RTS, Alfa Bank

Inflation is the key implication of sanctions

GDP growth remains strong thus far; inflation outlook has deteriorated

Judging by the growth rate, Russia is surviving well, posting 1H14 GDP growth of 0.8%; however, deterioration in the inflation outlook seems to be a key implication of the sanctions. Annual inflation was 7.5% y/y at end-July this year, and in the best case will accelerate to 7.7% in August. The consensus forecast for 2015 targets 5.6% annual inflation, which we take as a very optimistic view, as it does not price in a number of negative factors that could damage the growth outlook.

Ban on imports to generate more inflation in next 12 months

The ban on food imports from the US, EU, Canada, Australia, Japan and Norway is an obvious reason to raise the inflation forecast, and it may have a very negative long-term effect. The import ban affects products that represent 20% of Russia's CPI in total, is equivalent to a supply squeeze of 5%, and may contribute to 1ppt inflation in the next 12 months in the very best case.

Sales tax, VAT increase would also cause inflation

However, the import ban is not the only reason to be more negative on inflation, given the government's recent decision to introduce a regional sales tax (which could go up to 3%) or to increase the VAT rate, which is a negative development for the 2015 inflation outlook. A number of regions are experiencing problems with funding social obligations, thus we expect a tax increase will be widely used, being a one-off spike in price growth. In our estimate, introducing a sales tax adds at least 1ppt to the inflation rate, all else being equal.

Oil sector tax maneuvering inflationary

Oil sector tax maneuvering (likely to be approved for 2015) implies a higher tax burden on oil refineries, which, according to oil experts, is likely to cause a 5% increase in local gasoline prices – negative for inflation.

Tariff indexation to cause more inflation

Though Russia implemented a tariff freeze this year for corporate users, natural monopolies have asked for a 10% y/y tariff increase for 2015, which may add around 1.0-1.5ppt to inflation figures next year.

Ruble under pressure at very end-Aug, reaching RUB37/$, bringing more inflation

Finally, as the ruble exchange rate remains under pressure, we expect the pass-through effect to influence inflation negatively. On August 28-29, the exchange rate market came under a new round of pressure on fears of the escalating Ukraine conflict, thereby pricing in more potential sanctions. Since the CBR does not have a commitment to intervene before the ruble reaches RUB38/$, the exchange rate moved easily to a new historical low of RUB37/$.

We raise our 2015 inflation target to 8%; has negative implications for growth rate

The combination of restrictions on imports, the expected tax increase, the risk of a tariff hike, gasoline price growth and ruble depreciation all set a very negative picture for the 2015 inflation outlook, thus hurting inflation expectations. The CBR is thereby very likely to implement another rate hike this year to address these risks. However, as inflation shock is largely non-monetary, we believe that the ability to contain it through monetary instruments will be limited, and we set our inflation target at 8.0% for 2015.

We must downgrade our GDP growth rate forecast; AB-ICI will be under pressure

Having said that, we need to adjust our macro outlook, cutting our expectations of retail trade growth to 2.0% this year and 1.5% in 2015; however, this triggers a very modest adjustment in the GDP growth forecast, which we now see at 0.8% this year and 1.0% next year. Support should come from investment that is likely to deliver better-than-expected results, though the weak economic growth rate will drag down financial markets performance, thus putting pressure on AB-ICI.

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Overweight (O/W):	Expected total stock return > 15%
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